No. 20915 and No. 20916

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

TIM W. LILLIE and INGEBORG V. LILLIE, husband and wife (Docket No. 20915) and PEARL LILLIE, an individual (Docket No. 20916),

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONERS.

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BRIEF FOR PETITIONERS.

This is a proceeding pursuant to a consolidated Petition for Review of two (2) decisions of The Tax Court of the United States. The cases involve a deficiency in Federal income taxes of petitioners in the following amounts for the following calendar years:

Tim W. Lillie and Ingeborg V. Lillie (Docket No. 20915)

Year	Deficiency	Penalties § 6651(a)	Penalties § 6653(a)
1956	1,228.88	.....	None
1959	3,696.25	.....	None
1960	214.78	20.98	None
1961	976.76	.....	None
Total	6,116.67	20.98	None

Pearl Lillie (Docket No. 20916)

Year	Deficiency	Total
1960	7,607.38	7,607.38

The cases were consolidated and heard before the Honorable Howard A. Dawson, Jr. on May 7, 1965, at Los Angeles, California.

Unless otherwise indicated, figures in brackets herein refer to the page numbers of the printed record as prepared and filed April 6, 1966, by the Clerk of the United States Court of Appeals for the Ninth Circuit. Figures in parentheses preceded by the letters "TR" refer to the pages of the official transcript of the hearing before The Tax Court of the United States.

Jurisdictional Statement.

In accordance with §6213 of the Internal Revenue Code of 1954 (hereinafter for convenience referred to as the "1954 Code"), the taxpayers (petitioners herein), within 90 days after notices of deficiency in Federal income taxes for the years set forth above were mailed to them, filed in The Tax Court of the United States separate petitions for redetermination of such deficiencies (Document Nos. 3, 7), which petitions were duly docketed and the cases consolidated for trial, briefing and decision.

The Tax Court affirmed a portion of such deficiencies and denied a portion of such deficiencies in decisions entered under Rule 50 of the Rules of The Tax Court on January 20, 1966. [R. 30, 32.]

A Petition for Review was filed jointly by the taxpayers (petitioners herein) on March 2, 1966, in accordance with §7483 of the 1954 Code [R. 33], seeking review by this Court of the decisions of The Tax Court.

The jurisdiction of this Court to review the decisions of The Tax Court arises under §7482(a) of the 1954

Code, and venue herein is properly established in accordance with §7482(b) of the 1954 Code by virtue of the fact that the taxpayers (petitioners herein) filed their Federal income tax returns for the years 1956 through 1961 (the taxable years in which the subject deficiencies arise) in the office of the District Director of Internal Revenue at Los Angeles, California. [R. 1, 6.]

Even if a "clearly erroneous" showing were required (which is not the case), it is submitted that this Court has full jurisdiction to review this case under the circumstances. *Gillette Estate v. Commissioner,* 182 F. 2d 1010 (9th Cir., 1950), 39 A.F.T.R. 612.

Opinion Below.

The Findings of Fact and Opinion of The Tax Court in the cases were filed therein on October 14, 1965 [R. 11] and are offically reported in 45 TC No. 3.

Question Presented.

During the taxable years 1959, 1960 and 1961, the taxpayers were engaged in the business of feeding cattle for profit and reported their income on the cash receipts and disbursements method; they deducted the cost of payments made for feed as business expenses in the year of payment, and the sellers of feed reported these transactions as sales and reported the payments as income in the year of payment. The Commissioner of Internal Revenue allowed as a business expense only that portion of the deductions which represents feed actually consumed by the taxpayers' cattle in the year of payment and allocated the balance of the feed expense to the following year.

The question for decision is: Are payments for feed, all of which is ultimately consumed by cash-basis taxpayers' cattle, deductible expenses in the year of payment; or must such expenses be allocated to the year in which the feed is actually consumed?

Statutes and Regulations Involved.

Internal Revenue Code of 1954:

"Sec. 162. TRADE OR BUSINESS EXPENSES.

(a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ."

'Sec. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) GENERAL RULE.—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."

Treasury Regulations:

"Sec. 1.162-12. EXPENSES OF FARMERS.

". . . The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay . . ."

"Sec. 1.461-1. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) GENERAL RULE.—

(1) Taxpayer using cash receipts and disbursements method. Under the cash receipts and dis-

bursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid."

"Sec. 1.471-6. INVENTORIES OF LIVESTOCK RAISERS AND OTHER FARMERS.

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. *It is optional with the taxpayer which of these methods of accounting is used . . .*" (Emphasis added.)

Revenue Rulings:

Special Ruling, T. Mooney, Deputy Commissioner, Dec. 16, 1943:

"Reference is made to your letter dated December 4, 1943, in which you state that several individual cattle feeders are located in your district who file their income tax returns on a cash receipts and disbursements basis. The individuals purchase large amounts of grain in addition to crops raised, all of which are for feeding purposes. The cattle in question are purchased and usually sold in the year subsequent to the year of purchase.

"You request to be advised whether the cost of the feed purchased should be deducted in the year payment therefor is made or whether it should be apportioned to the year in which it is consumed; or, in other words, whether it is considered to be an item of general expense or an item to be considered in computing gross income.

"In the case of a taxpayer on the cash receipts and disbursements basis, the amounts expended

for feed should be deducted as an expense in the year in which the feed is paid for, irrespective of the fact that it may not be consumed until the following year. (Letter to Collector of Internal Revenue, Des Moines, Iowa, dated Dec. 16, 1943, signed by T. Mooney, Deputy Commissioner.)"

Errors Relied Upon.

1. The characterization by The Tax Court of payments for feed as "deposits" was erroneous and determinative of the results in this case, and the inferences and conclusions drawn by The Tax Court to arrive at such characterization were based on errors and a misreading of the evidence. From this characterization, The Tax Court "bootstrapped" itself to what it denominated a "finding of fact" but which, in truth, was a finding of ultimate fact—a mixed question of law and fact subject to full review by this Court on appeal.

2. The conclusion of The Tax Court that, because a "portion" of the purchase price paid for feed included some prepayment for "services" to be performed at a future date, therefore the *entire* price paid for feed must be characterized as prepayment for services was erroneous.

3. The characterization by The Tax Court that the repurchase of taxpayers' feed inventory by McCabe Cattle Co. in 1961 in settlement of a dispute and upon termination of a feeding agreement amounted to a "refund" was erroneous.

4. The conclusion of The Tax Court (after characterizing the repurchase of feed by McCabe in 1961 as a "refund") that because taxpayers received *one* "refund" in *one* year, in a single, isolated transaction, that there-

fore *all* feed purchases in *all* years from *all* feed suppliers should be characterized as "deposits" was erroneous.

5. The statement by The Tax Court at page 8 of the reported opinion [R. 18] that taxpayers were not required to pay for feed in advance of consumption is erroneous and directly contrary to the evidence presented in the case.

6. It was error for The Tax Court to fail to distinguish its holding in the case of *John Ernst v. Commissioner,* 32 T.C. 181 (1959) from the instant case. At pages 14, 15 of the reported opinion in this case [R. 24, 25] The Tax Court distinguished *Ernst* from the case of *Cravens v. Commissioner,* 272 F. 2d 895 (C.A. 10, 1960), 60-1 U.S.T.C. ¶9139, reversing 30 T.C. 903, but failed to indicate any valid reason for not following *Ernst* in the present case.

7. The statement by The Tax Court at page 17 of the reported opinion [R. 27] that petitioners were "charged the current market price, not a predetermined price, when the feed was consumed . . ." is erroneous and directly contrary to the evidence (Tr. 44, 71, 84, 99, 101 and 116) and agreed facts contained in the Supplemental Stipulation of Facts [R. 8].

Statement of Facts.

Tim W. and Ingeborg V. Lillie are husband and wife, and Pearl Lillie is the mother of Tim. Ingeborg is a party to this action only because she filed joint income tax returns with her husband; therefore, where the words "petitioners" and "taxpayers" are used, they refer to Tim and Pearl. Both petitioners keep their books and report their income on a calendar year basis and

on the cash receipts and disbursements method of accounting.

During the years 1959, 1960 and 1961, Tim fed cattle for profit in Imperial County, California. Pearl joined him in this venture in 1960, and both have been actively engaged in the cattle business ever since.

The cattle owned by petitioners during these years were located in the commercial feed yards of Heber Cattle Feeders and McCabe Cattle Co. Petitioners entered into oral agreements with Heber and McCabe whereby petitioners were obligated to pay in advance for feed purchased for consumption by their cattle. (Tr. 13, 76, 83.) Toward the end of each year petitioners made payments to Heber and McCabe for feed and deducted such payments as expenses in the year of payment. The sellers reported those transactions as "sale" of feed and reported their receipts for tax purposes as "income" from sales.

At all times when payments for feed were made, petitioners had cattle on hand and all of the feed purchased was ultimately consumed by petitioners' cattle with the exception of one portion of feed inventory at McCabe in the year 1961, which portion was resold to McCabe upon discontinuance of feeding cattle at McCabe as the result of a dispute between McCabe and petitioners.

In every feed purchase transaction pertinent to this proceeding, both the seller and the buyer envisioned no refund of any amounts paid and no provision was made for any "refund" (Tr. 14, 19, 22, 23, 65, 67, 80, 107, 110, 136); Opinion—Findings of Fact at pages 6 and 7. [R. 16, 17.]

Historically, the custom and practice in the cattle-feeding industry in Imperial Valley, from the earliest

time cattle were custom-fed commercially by feed-sellers up to and including the present time, is to sell feed at a certain price per ton which includes ingredients, mixing, delivery to the pens and use of the sellers' corrals. Sellers do not segregate the costs of "services" for mixing and delivery, etc. The actual cost or ingredients furnished to the customer comprises more than ninety (90%) percent of the sale price of the feed, and that amount can readily be determined on any given date.

The custom cattle-feeding business is a highly competitive industry, and the sales potential of the seller depends on the numbers of head of cattle of customers each seller can adequately house and feed in his "yard" (corrals). Each customer makes his own agreement with the feed-seller as to method of payment for feed based on the customer's history and credit rating. Some customers who are new to the business and whose only collateral for feed is the number of cattle located in the yard are required to pay for feed in advance; others with a history and other collateral are permitted to "accrue" feed bills until their cattle are sold; others may pay for feed consumed by computing the amount of "gain in weight" put on the cattle over a period of time multiplied by a price-per-pound formula. Petitioners, at the times pertinent to this determination, were required to pay for feed in advance. (Tr. 13, 76, 83.)

At all times pertinent to this determination, neither the sellers of feed nor petitioners intended payments to be "deposits" (Opinion [R. 28]; Tr. 63, 76, 79, 94, 107, 109, 135; Ex. 9-I, P, Q, R, S and T), and the price of feed consumed by petitioners' cattle was accounted for at the price as of the time of payment and not as of a subsequent date when consumed. (Tr. 44, 71, 84, 99, 101 and 116.)

ARGUMENT.

Preliminary Statement.

Although the issue in this proceeding involves the disallowance of deductions of certain payments made for cattle feed by cash-basis taxpayers in the year of payment, The Tax Court precluded a fair determination of the issue by characterizing the payments as "deposits" prior to an analysis of the evidence and the law. After thus assuming the ultimate issue of the case and denominating it a "finding of fact", the Court then attempted to justify such a "finding", and in so doing drew erroneous inferences and conclusions which should leave this Court with the definite and firm conviction that a mistake has been made by The Tax Court.

Whether the payments made were in consideration of the purchase and sale of feed or "merely deposits" was not a question properly before The Tax Court and is a question which should be decided by the law of sales. The decision of The Tax Court on this point (*having not been tried below* is contrary to the law of sales as established by the cases of *Percy W. Phillips,* 30 T.C. No. 87 (1958), and *Jack Benny,* 25 T.C. 197 (1955), and therefore is subject to complete review by this Court.

The provisions of §§162(a) and 461(a) of the 1954 Code, *supra,* have been a part of the Federal tax law, without material change, for over twenty years. They provide that a cash-basis taxpayer shall be entitled, as a matter of law, to deduct all ordinary and necessary expenses incident to the conduct of a trade or business in the year of payment.

Petitioners submit that the opinion of The Tax Court in this case has distorted the true issue of determining the year of deductibility of payments made for livestock feed into two issues which were not tried below:[1]

(a) What constitutes a "deposit"?

(b) Does the inclusion of "services" in the cost of feed disqualify a cash-basis purchaser from deducting the cost of ingredients in the year of payment?

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[1]The determination by this Court on these questions will have far reaching consequences. The case at hand is a test case in which much more is at stake than the deficiencies involved. This case represents an attack by the Commissioner on the continued availability of the cash-basis method of accounting for persons engaged in the cattle-feeding industry. As this case comes before this Court on appeal, the District Director of Internal Revenue for the Los Angeles, California, District has a large backlog of audits pending in Imperial County in which the Reviewing Agent has been instructed to deny deductions to any cattle feeders who prepay feed expenses and to force such taxpayers to keep inventories. At the same time, the Reviewing Agent has been instructed to deny claims for adjustments to inventories of feed sellers on amended returns where the seller reports prepayments of feed as "deposits". These taxpayers are being requested to execute extensions of the statute of limitations pending the outcome of this case on appeal.

It is submitted that if this attack by the Commissioner is successful there will be no feasible way for a cash-basis cattle-feeder to obtain an expense deduction for the purchase of fungible goods in advance of their consumption because of the inclusion in the price of feed of certain "services" which are yet to be performed by the seller (feed lot operator). This could result in serious economic chaos in the custom cattle-feeding industry which is now one of California's largest industries. Credit policies of all custom feed lot operators could be placed in serious jeopardy, and the number of cattle being fed in custom feed yards would be greatly reduced.

It is further submitted that the revenue to the Treasury Department will not be increased or diminished significantly by upholding the position taken by the Commissioner in this case, since the deduction denied in one year must be allowed in the following year when the feed is consumed. In the instant case, the ultimate position of petitioners resulted in a net refund after the subsequent years were adjusted to reflect the decision of The Tax Court concerning the taxable years under litigation.

The status of the law, as pronounced by decisions of the courts in *John Ernst v. Commissioner,* 32 T.C. 181 (1959), *Cravens v. Commissioner,* 272 F. 2d 895 (CA-10, 1960), reversing 30 T.C. 903, 60-1 U.S.T.C. ¶9139; *Shippy v. United States,* 199 F. Supp. 482 (D.C. W. Dist. SD., 1961), 62-1 U.S.T.C. ¶9203, and the published policy of the Commissioner of Internal Revenue, as set forth in Letter Ruling, T. Mooney, Deputy Commissioner, December 16, 1943, (as published in full at ¶66.149 of Prentice-Hall Federal Tax Service, 1944), prior to the opinion of The Tax Court in this case, was as follows:

> Advance payments for feed made by cash-basis taxpayers are deductible in the year of payment where the following criteria is met:

(1) Where the cash-basis purchaser of feed made payments which were absolute and the purchaser was irretrievably out of pocket the amounts paid; (*Ernst, supra*)

(2) Where purchaser used the feed in carrying on a trade or business; (*Ernst, supra*)

(3) Where the seller was unconditionally obligated to deliver to purchaser the quantity of feed which the amounts received would pay for *at the prices in effect on the dates of delivery;* (Emphasis added) (*Ernst, supra, Cravens, supra*)

(4) Where both the purchaser and seller regarded the transactions as a "sale" and not a deposit and so reported it on their books of account; *Shippy, supra*)

(5) Where there was no contractual provision for or contemplation of a refund by the parties at the time of payment; (*Ernst, supra*)

(6) Where the agreement between purchaser and seller was binding and was carried out by the parties; (*Cravens, supra*)

(7) Where the amount of the price was "paid" or "incurred" within the taxable year. (*Cravens, supra*)

(8) The published policy of the Commissioner of Internal Revenue is stated as follows:

"Reference is made to your letter dated December 4, 1943, in which you state that several individual cattle feeders are located in your district who file their income tax returns on a cash receipts and disbursements basis. The individuals purchase large amounts of grain in addition to crops raised, all of which are for feeding purposes. The cattle in question are purchased and usually sold in the year subsequent to the year of purchase.

"You requested to be advised whether the cost of feed purchased should be deducted in the year payment therefor is made or whether it should be apportioned to the year in which it is consumed; or, in other words, whether it is considered to be an item of general expense or an item to be considered in computing gross income.

"In the case of a taxpayer on the cash receipts and disbursements basis, the amounts expended for feed should be deducted as an expense in the year in which the feed is paid for, irrespective of the fact that it may not be consumed until the following year. (Letter to Collector of Internal Revenue, Des Moines, Iowa, dated Dec. 16, 1943, signed by T. Mooney, Deputy Commissioner.)"

Until the language of the opinion in this case was issued, neither the courts nor the Commissioner had ever considered that the indirect costs and overhead of the feed-seller, which were included in the sale price of feed, were such "significant" services that the entire sales transaction should be characterized as "prepaid services" or "deposits." This novel theory, if permitted to stand, would nullify the law of sales.

I.

The Payments by Petitioners Meet All of the Requirements Established by Tax Law and the Law of Sales to Qualify as Purchases of Feed and Were Not "Merely Deposits".

The Tax Court in this case admits that it [The Tax Court] held in *Ernst v. Commissioner, supra,* that the petitioner was entitled to a deduction of "substantial" payments for feed made by a poultry feeder to his feed supplier in December of each year as ordinary and necessary expenses in the year of payment although the feed was not to be delivered until the succeeding years, the price was to be determined as of the subsequent date of delivery, the buyer "had no [none] need for the quantities of feed he paid for at the time of payment", and neither a sale nor sales income was taken into account on the books of the grain dealer until the feed was delivered in the succeeding years. [R. 24.] The Tax Court then relied upon its prior language in the *Ernst* case in distinguishing that case from *Cravens v. Commissioner, supra,* and sets forth the criteria used to determine that the poultry feeder's payments were *"not in the nature of deposits"* (Emphasis added):

(1) There was no contractual provision for a refund.

(2) The payments were absolute, and petitioner was irretrievably out of pocket the amounts paid.

(3) The payments were incident to carrying on a trade or business.

(4) Seller was obligated to deliver such quantity (unknown at the time of payment) of feed as the price to be in effect at the future date of delivery would use up.

In the instant case, petitioners rely on the standards established by The Tax Court in *Ernst, supra:*

(1) The Tax Court found [R. 16, 17] that payments by petitioners to McCabe in 1960 were made with *"no provision for the refund* of the sums paid" and that the termination of feeding relationship between petitioners and McCabe which gave rise to the resale of feed inventory to McCabe *"had not been envisioned the previous December when he* [*they*] *made his* [*their*] *advance payments."* (Emphasis added) All parties were of the belief at the time of payments that there was no possibility of refunds. (Tr. 14, 19, 22, 23, 65, 67, 80, 107, 110, 136.)

(2) The Tax Court found [R. 20] that petitioners are "engaged in the business of raising cattle for profit" and "are entitled to deduct the cost of feed as an ordinary and necessary business expense under the provisions of §162(a) of the Internal Revenue Code of 1954." (Incident to carrying on a trade or business)

(3) The payments were absolute, and petitioner was irretrievably out of pocket the amounts paid. In fact the payments were intended, recorded on the

books of account of seller, and returned for Federal income tax purposes by *both* buyer and seller as completed sales transactions. (Tr. 63, 76, 79, 94, 107, 109, 135; Ex. P, Q, R, S and T.) Under the law of sales of the State of California, purchaser would have no legal basis for claim for refund.

(4) In the instant case, there can be no question that a binding oral contract existed between petitioner and feed suppliers. Under basic, hornbook law of contracts where there has been an offer and acceptance, complete performance by one party (buyer) and partial performance by the other party (seller), mutual consideration, an unmistakeable meeting of the minds as to the intent of the parties, a legal purpose, and both parties competent, a binding contract exists. *Dartmouth College v. Woodward,* 4 Wheat. (U.S.) 518, 4 L. Ed. 629.

(5) In the instant case, the prices were established as of the date of payment—not to be determined at the future delivery date. (Supp. Stip. [R. 8]; Tr. 13, 76, 83.)

(6) In the instant case, the feed was *on hand* and "earmarked" and *delivered* (as fungible goods) as of the date of payment. (Tr. 15, 63.) The "quantum" was capable of immediate computation by use of the "mix" formula. Petitioners' cattle actually consumed part of the feed in the year of payment.

(7) In the instant case, petitioners had *immediate* need for a portion of the feed purchased and

subsequently used all the feed for the same cattle on hand at the date of purchase (with the exception of the isolated "incident" at McCabe in 1961).

The Tax Court stated in its opinion in this case [R. 23] *"that the possibility of a refund did not make the amount a deposit* [in *Cravens, supra*] *since the contract was binding and was carried out* by the parties." (Emphasis added.) Petitioners submit that in the instant case the agreements were binding, carried out by the parties, and additional feed subsequently purchased and consumed for the same cattle.

Petitioners submit that the facts in the instant case fall squarely within the criteria and the holding of the U. S. Court of Appeals for the Tenth Circuit in *Cravens v. Commissioner, supra*, and the Tax Court in *Ernst v. Commissioner, supra.*

In the case of *George R. Shippy v. United States, supra,* a deduction for advance payment for feed was denied because:

(1) The arrangement between the purchaser and the elevator (seller) was *not a contract.*

(2) The seller regarded the arrangement as a "deposit" and so recorded it on his books of account.

(3) Payment in advance was not requested or demanded by the seller.

(4) The parties both contemplated a "refund" in the event future deliveries were not requested or made.

(5) Feed was supplied from time to time in quantities ordered at each future date at the price in effect on the date of each delivery.

(6) Buyer had a history with seller of paying *AFTER* feed was delivered—never in advance; then in the pertinent year involved, the payment was triple the normal purchases, *in advance.*

Petitioners submit that *Shippy* was decided correctly on its peculiar facts and that the instant case is patently distinguishable in that *none* of the above criteria of that case is found in the instant case. In the case at bar there were *binding contracts,* the parties recorded and paid taxes on the transactions as *completed sales,* there were *no provisions for or contemplation of refunds,* feed was on hand and *delivered* in a determined amount, the *price was fixed as of the date of payment* and not at a future undetermined price, there were no prior histories of payments *after* feed was consumed, and the amount of year-end purchases were uniform and *not abnormal* compared to amount of feed which was needed to feed cattle on hand.

II.

The Fact That Deductions for Feed Payments Had the Effect of Reducing Petitioners' Taxable Income for a Particular Year Is Immaterial.

Petitioners have admitted that one of the reasons payments were made in advance was because of the tax advantage. By purchasing feed in advance, petitioners had the advantage of "using" money which would not have been available without the tax deduction in the year of payment. *But this is not the issue in this case.*

So long as the purchase of feed was an ordinary and necessary business expense of petitioners' cattle-feeding business (*and The Tax Court so found* [R. 20]) it is wholly immaterial that petitioners selected a time for the purchase which would gain them tax advantages. The courts have long recognized that it is not improper to avoid or minimize taxes if lawful means are used and the transactions are not "shams". In the famous case of *Gregory v. Helvering,* 293 U.S 465 (1935), the United States Supreme Court said, at page 469:

> "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether to avoid them, by means which the law permits, cannot be doubted . . ."

Petitioners submit that the rule of The Tax Court itself, with reference to the law of sales, is clearly stated in *Percy W. Phillips,* 30 T.C. No. 87 (1958). In that case the court held that a bona fide sale *must* be recognized even though it is made for the *"sole purpose of minimizing taxes."* The same rule was clearly stated in *Jack Benny,* 25 T.C. 197 at pages 210, 211 (1955).

The Internal Revenue Service, in Rev. Rul. 58-162, C.B. 1958-1, 234, recognizes that cash-basis taxpayers may control the timing of income. In that ruling a cash-basis wheat farmer sold and delivered wheat to a purchaser under contracts calling for payment during the following year. The Service ruled that cash-basis farmers need only to report income in the year of receipt and that so long as such contracts are bona fide, they are effective to postpone [or accelerate] the realization of income.

III.

Certain Statements and Findings of Fact of the Tax Court Are Contrary to the Evidence.

A. The Tax Court Ignored or Misinterpreted the Supplemental Stipulation of Facts.

The Tax Court ordered a Supplemental Stipulation of Facts for the express purpose of resolving certain conflicting testimony as to whether the cattle feed-sellers (Heber and McCabe) charged petitioners for feed consumed at (1) the price determined at the time payment was made for the feed, or (2) the current market price at the time the feed was consumed (a matter which is immaterial if the *Ernst* and *Cravens, supra*, cases are followed).

Paragraph 1 of this Supplemental Stipulation states [R. 18]:

> "1. Heber Cattle Feeders: The price of #1 mix feed was $50.00 per ton from December of 1959 through September 1960. . . . The statement of Heber, joint Exhibit 9-I, states that Tim Lillie *purchased* #1 mix feed *at $50.00 per ton.* Tim Lillie was charged for #1 mix feed *consumed at $50.00 per ton* from December 1959 to August 1960." (Emphasis added.)
>
> *NOTE*: The only cattle fed by petitioners at Heber during this period were fed from December 21, 1959 through August 21, 1960, and all #1 mix feed was accounted for at $50.00 per ton. (Ex. 10-J.) Petitioners did not feed cattle again at Heber until after the dispute with McCabe in July of 1961. In July of 1961, petitioners again fed cattle at Heber, and this lot was completed in Jan-

uary of 1962, with all feed purchased and consumed during a period which the Supplemental Stipulation shows the price remained unchanged. (Supp. Stip. Para. 1 [R. 8]; Ex. 11-K.)

Paragraph 2 of the Supplemental Stipulation stated [R. 9]:

"2. McCabe Cattle Co.: The price of #1 mix . . . was $52.30 per ton from November 1960 through August 1961, for all customers."

NOTE: Petitioners' cattle were started on feed purchased in November 1960 and were all completed and shipped as of July 1961—a period when the price did not change; therefore, the price *was in truth* the same at the date of consumption as at the date of payment. (Tim W. Lillie Stip. para. 8 [R. 3]; Pearl Lillie Stip. para. 5 [R. 7], Ex. 12-L, 13-M.)

Petitioners submit that the Tax Court was less than accurate when it stated [R. 27] that the evidence "shows that petitioners did not fix the price of feed at the market price on the date of payment" and that "they [petitioners] were charged the current market price, not a predetermined price, when feed was consumed."

Petitioners further submit that if *Ernst v. Commissioner, supra*, is still as virile as The Tax Court in this case says it is, the question of "fixing" the price is immaterial since in that case the price was to be *as of the date of future delivery.*

B. The Tax Court Ignored the Uncontradicted Testimony of Certain Witnesses.

The Tax Court stated [R. 18] that petitioners were *not* "required to pay for feed in advance of consumption". Yet the uncontradicted testimony of witnesses Virgil Torrence (Tr. 76), Paul Milstead (Tr. 83), and Tim Lillie (Tr. 13) shows that the agreement between petitioners and the feed sellers *required payment in advance.* (Emphasis added.)

The Tax Court stated that "customers of Heber and McCabe *could* pay monthly for the cost of feed consumed by their cattle and many of them did so." [R. 18.] Yet the uncontradicted testimony showed that although many different methods of payment were available to *other* customers—(and in fact in later years, after petitioners had a history in the business, such "deals" were available to them) at the time pertinent to this case *prepayment was a condition of petitioners' agreement* with feed suppliers. (Tr. 13, 76, 83.) (Emphasis added.)

C. The Tax Court Ignored the Clear Statement of the Applicable Tax Laws Announced by the U.S. Court of Appeals for the Tenth Circuit.

The Tax Court quoted the United States Court of Appeals for the Tenth Circuit [R. 24] as setting forth the Federal tax law and Congressional intent governing the deductibility of advance payments for feed as follows:

> "In the case of farmers and cattle raisers the use of a transactional basis for the computation

> of income would bring confusion into the federal tax system. The treatment of the cost of seed, fertilizer, and feed purchased in one year for use in the next year is simple if the deduction is allowed when paid if the cash basis applies or when incurred if the accrual basis is used.[20] If each transaction must be analyzed to determine whether a distortion of income will result from the allowance of a business expense deduction, §43 is, in our opinion, given a meaning which Congress did not intend. [Footnotes omitted.]"[2]

However, The Tax Court then ignored this statement of the law and distinguished the instant case *solely* on the strained and unnatural theory that the payments were not actually for feed but for "services" to be performed and that this fact, together with a "refund" [repurchase] in one year by one supplier, removed petitioners from the availability of the law. Petitioners submit that this was reversible error.

D. The "Deposit" Theory of the Tax Court Is Inconsistent With the Record and Would Be Conclusive on the Issue of the Existence of a Binding Obligation.

The Tax Court found it "unnecessary" to decide the Government's primary contention at the time of trial; namely, that the allowance of the deductions of payments in question would distort petitioner's income. This unnecessity was occasioned by the Court's being lured into the finding of a "deposit" due to the so-

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[2]Section 43 of the Internal Revenue Code of 1939 is now §461(a) of the 1954 Code.

called "refund" in 1961 and the inclusion of the cost of services in the price of feed. [R. 27.] Once The Tax Court characterized the payments as deposits, the case was solved. However, sound reasoning would dictate that if the deposit theory were adopted, The Tax Court would then be obligated to follow *Ernst, supra,* and the record would preclude any other choice:

(a) If there were a true sales "deposit" (a down-payment in the normal, ordinary business sense of the word), there would automatically be a "binding obligation", *i.e.,* a firm sale contract which would then permit the parties to control the year of payment. Rev. Rul. 58-162, CB 1958-1, 234; *Percy W. Phillips, supra, Jack Benny, supra.* Therefore, by finding a "deposit", the Court finds a binding sales contract.

(b) If there were a bailment or surety type "deposit", then the sellers would hold the property in a fiduciary capacity and not be entitled to the beneficial use thereof. But the record here is inconsistent with this theory because the uncontroverted evidence established that the suppliers had unrestricted use and enjoyment of the funds paid and no contractual provisions for refunds were made or even contemplated by the parties at the time of payment. [R. 16]; (Tr. 14, 19, 22, 23, 65, 67, 80, 107, 110, 136.) In fact, the sellers in the instant case paid tax on the proceeds which they treated as "income".

Petitioners submit that neither the facts nor the law support a finding that the payments in question were deposits in the "bailment" or "surety" sense of the word. And if they are deposits in the "sales" sense of the word, the ultimate decision of The Tax Court must be reversed.

In The Tax Court, the Government cited several cases purporting to support their theories of deposit and distortion of income. Their inapplicability to the instant case has been covered in Petitioners' Brief and Reply Brief filed in that Court, and mention is made of this matter to alert this Court that, in the event the Government should choose to rely upon them again in this appeal, the information contained in petitioners' briefs should be included in these proceedings. The respondent has cited *Galatoire Bros. v. Lines,* 23 F. 2d 676 (C.A. 5, 1928), 6 A.F.T.R. 7213 ("advance rental payments by lessee"); *Robert S. Bassett,* 26 T.C. 619 (1956) ("prepaid medical expenses"); and *Boylston Market Ass'n v. Commissioner,* 131 F. 2d 966 (C.A. 1, 1942), 30 A.F.T.R. 512 ("prepaid insurance premiums"). These cases involve well recognized exceptions to the general rule that expenses may be deducted by a cash-basis taxpayer in the year of payment. As a matter of fact, the rule of *Boylston Market Ass'n., supra* has been rejected in *Waldheim Realty & Investment Co. v. Commissioner,* 245 F. 2d 823 (8th Cir., 1957).

IV.

The Fact That the Price of Feed Included Incidental "Services" Already Performed and to Be Performed by Sellers Does Not Constitute a Reasonable Basis for Denying a Deduction for Payments Made for Feed Ingredients and Services Performed in the Year of Payment.

It must be pointed out that the issue of the *value* of services "to be rendered by suppliers" in years subsequent to the year of payment was never tried below. At no time during the trial did the Government intimate or indicate that it was contending that a "substantial" portion of the price charged for feed included services *yet remaining to be performed* AFTER *the year of payments*. Only passing testimony that suppliers considered the services they rendered to be "significant" was introduced; and one witness made an enumeration of various services which *could* be performed for customers. There was no testimony of the specific services which were, in fact, performed for petitioners. Consequently, the evidence on this point is not probative and the record certainly does not justify a holding that the cost of such services were "substantial" in relation to the price of feed. *A fortiori* the record does not justify a holding that the *entire* price of the feed constitutes prepayment of services to be rendered in years subsequent to the year of payment.

The inapplicability of cases cited by the Government in its briefs below to support the position that advance payments for services to be performed in subsequent

years were not deductible was adequately covered in petitioners' briefs filed in The Tax Court and are now made a part of these proceedings for the same purpose in the event the Government should choose to rely upon them again in this appeal.

A. The Tax Court Erred in Not Permitting Petitioners to Deduct "That Portion" of the Price Paid for Feed Which Included Feed Ingredients and Services Performed in the Year of Payment.

In its opinion the Tax Court repeatedly emphasized that its decision was predicated on the "inclusion of services in the cost of feed to be consumed by petitioners' cattle in the future". But the Court admitted that only "*that portion*" of the cost of feed *attributable to future services* to be rendered was not deductible until the services were performed. (Emphasis added.) At page 17 of the opinion [R. 27] the Court stated:

> "And finally, the petitioners' cost of 'feed' included valuable and significant services rendered by both of the cattle feeding companies. *That portion of the cost* was nothing more than a deposit for the payment of services to be supplied in the future. Such *an amount* is deductible only when the services are performed." (Emphasis added.)

Although, in the opinion of The Tax Court, "such amount" was deductible only in the year performed, it denied the deduction of the *entire amount of payments.* Obviously, the Court has made a simple mistake, although a serious one.

If the value of services "to be performed in the future" is to be *excluded* from the price of feed deducted in the year of payment, then it must reasonably follow that the value of services "already performed" must be *included* in such price and is deductible. In the instant case, a great majority of the so-called "substantial" services rendered by sellers were performed PRIOR to the end of the year in which payment was made. Of those services enumerated by The Tax Court [R. 14], all of the unloading, branding, dipping, weighing, dehorning, castrating, recording and placing in pens would have been *performed* IN THE YEAR OF PAYMENT. In this case, the only significant service "to be performed" by the feed sellers would have been the delivery of feed from the storage area to the cattle in the pens.

B. It Was Error for the Tax Court to Construe Certain Incidental Services Which Suppliers Considered "Significant" as Being "Substantial" in Relation to the Total Price Charged for Feed.

The feed suppliers testified that they considered certain services which they perform for customers (not *all* of which are furnished to *every* customer) to be "significant". The Tax Court erroneously construed "significant" to mean "substantial"; it compounded this error by assuming that the cost of such services was substantial in relation to the price charged for feed.

Petitioners submit that this fallacy resulted in a conclusion which is clearly a mistake. It also raises an issue as to what constitutes "feed" within the language of §162(a) of the 1954 Code and §1.162-12 of the Regulations thereto. This issue has not been tried.

The books of account of the custom cattle-feeders throughout Imperial Valley will verify the fact that *all* of the services performed for customers do not constitute ten (10%) percent of the total price charged for feed, including ingredients. Although the exact amount of overhead costs which were included in the price of feed charged by Heber and McCabe to petitioners might not be readily available, the cost of ingredients can easily be ascertained from their records. *This point was not considered by The Tax Court or counsel for either side below.*

As a matter of general information, a very small number of cattle are dipped, dehorned or castrated *in the feed yards.* All of petitioners' cattle were steers at the date of purchase and were already in the pens and on feed when they were purchased. Petitioners purchased *All* of their cattle f.o.b. the feeds pens of the custom cattle-feeders, and the freight, delivery and handling costs of any cattle which were "shipped in" for petitioners were billed separately. The petitioners' tax returns reflect these costs as part of the cost of cattle (Exs. 1-A, 2-B, 3-C, 4-D, 5-E, 6-F, 7-G, 8-H, they *Are Not Included* in the payments made for feed. Medical services and supplies were also billed and paid for separately. (Tr. 75, 76.)

Therefore, it is obvious that not *all* of the services referred to by The Tax Court [R. 14] were furnished to petitioners, either in the year of payment or in subsequent years.

The Tax Court decided these cases below solely on the "deposit" theory, and admitted that this theory was adopted because of the inclusion in the price of feed of "services yet to be performed" and the single incident

of a so-called "refund" in 1961 which was not contemplated at the time of payment. The Tax Court stated in its opinion that it is not considering the alternative contention of the Government that to allow the deductions would distort income, but since it has already changed the issue in this case once (without trial of the new issue), petitioners would be remiss in not urging again the arguments set forth in briefs below on that "alternative" issue.

Conclusion.

Petitioners submit that The Tax Court, by deciding issues which were not tried in these cases and by finding facts which were not supported by the evidence, has demonstrated a great pioneering spirit in attempting to extend the frontier of the Commissioner of Internal Revenue's attack on the use of the cash basis method of reporting income by farmers and livestock feeders.

It is respectfully submitted that petitioners have established that they are entitled to expense deductions for payments made for feed in 1959, 1960 and 1961, and that the Commissioner's disallowance of those deductions, which was upheld by The Tax Court, should be reversed.

Respectfully submitted,

CHARLES A. PINNEY, JR.,
Attorney for Petitioners.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

CHARLES A. PINNEY, JR.

APPENDIX I.

EXHIBITS.

(Rule 18(2)(f) of the Rules of the United States Court of Appeals for the Ninth Circuit.)

Exhibit Number	Received for Identification	Offered into Evidence	Received into Evidence
Stipulation of facts and joint Exhibits 1-A through 13-N		TR. 3	TR. 3
N	TR. 50	TR. 52	TR. 52
O	TR. 52	TR. 53	TR. 53
P	TR. 90	TR. 91	TR. 91
Q	TR. 90	TR. 91	TR. 91
R	TR. 91	TR. 91	TR. 91
S	TR. 125	TR. 127	TR. 127
T	TR. 126	TR. 127	TR. 127
U	TR. 126	TR. 127	TR. 127

Supplemental Stipulation of Facts — Filed June 1, 1965 — [R. 8]